QUARTERLY MARKET COMMENTARY

For the past year we have been suggesting to clients that a stockmarket fall was looking increasingly likely. The FTSE 100 Index reached an all-time high of 7,778 on 12 January this year but since then we have seen the index decline to around 7,080 (at the time of writing). To a UK investor, this is a 9% decline in value over the last 7 weeks.

Does the recent performance reflect fundamental issues and concerns from investors on the future direction of global growth or is this just a short-term technical correction? We explore this in further detail below.

To some extent the performance of the FTSE 100 Index should be viewed in light of performance and returns in general from other leading indices. Also important, is the period in which returns are measured. UK and European stockmarkets are generally in negative territory over the last year, whilst US stockmarkets have remained strong and positive. However, this follows a period when UK and European focused investment funds had performed extremely well. This does not necessarily mean that current economic fundamentals remain more supportive in the US compared to the UK and Europe, but can largely be attributed to the recent weakness of the US Dollar.

In the period following the BREXIT result in June 2016, the value of Sterling declined against the US Dollar and by January 2017 was some 20% lower. Sterling was 11% lower against the Euro over the same time period. This had the benefit of enhancing positive investment returns on overseas equity funds for UK based investors when the impact of currency conversions was also taken into account.

In recent months there has been a paradoxical shift on currency performance with the US Dollar weakening and Sterling (and to a lesser extent, the Euro) strengthening. Given that over 70% of company revenue from FTSE 100 listed companies is reported in US Dollar it is perhaps no surprise that the leading UK index is in negative territory over the last year.

However, what was noticeable at the beginning of this year was the speed at which certain stockmarkets fell, especially as no specific ‘market threat’ news had been announced. So, what caused the initial sell-off? In one word – volatility.

You may have noticed that stockmarkets have been very calm over the last few years. They have steadily risen in a well-behaved manner and have not done much to scare the populus. In other words, they have not been volatile.

As a result, the VIX Index – which is one measure of volatility – has been very low. The VIX Index measures, at any given time, the number of options written on the US S&P market. The higher the number of options written by fund managers, the greater the view that the US S&P is due to fall. Accordingly, taking a survey of the number of participants expecting the market to fall could determine to what extent the market does fall. Therefore, the VIX Index is somewhat ‘self-reflexive’.

As the VIX Index has been low, many people decided to bet on the VIX Index remaining low. Unfortunately, when there is a trend, you will find people who want to bet on that trend continuing and financial markets created new ways to bet on the VIX. However, when lots of people are betting on volatility remaining low, that actually helps to push it lower. The slightest increase, which we witnessed in certain equity and bond markets, resulted in ‘low volatility’ trading strategies having to unwind positions. This increase in volatility, resulted in ‘low volatility’ strategies unwinding further positions, thus increasing volatility further and so on.

These ‘low volatility’ trading strategies are usually computerised, mathematical algorithms, which can quickly exacerbate a trend but cannot ask the question; ‘does this reflect the true nature of the environment we are in?’ This is ultimately what we have witnessed from the second half of January onwards with computerised systems determining demand and supply and so the stockmarket correction to date has not been based on fundamental economic concerns.

So, I hear you cry, can we all relax and look forward to benign investment markets, rising values, supported by central bank policy. We think the simple answer to that is ‘no’.

What has become apparent this year is that investors are starting to wake up to the fact that the life support system that has largely been in place since the Financial Crisis in 2008 is being removed. Stepping back a decade ago, we had massive central bank intervention. This was a combination of ultra-low interest rates being introduced and various different forms of Quantitative Easing ‘QE’, which included pure money printing in the US, UK and Europe and the ‘bond yield curve’ control system adopted by the Bank of Japan.

As a result, the cost of credit reduced, the money supply increased and this allowed various factions of the financial system to manage their balance sheets accordingly. The increased money supply also pushed asset prices higher. The economic impact of central bank policy in the US, UK and Europe has seen unemployment fall to multi-year lows, wages increase and a general rise in corporate productivity. State spending, particularly in the US, has also risen.

As a result, the QE programme in the US is now being reversed, commonly referred to as Quantitative Tapering ‘QT’, with the significant reduction of the Federal Reserve’s bond buying programme being seen. Europe is expected to start QT later this year. However, what is starting to worry markets is inflation. There is a growing view that there is a very close parallel to today’s environment; in the latter half of the 1960s, the US had extremely low unemployment – in 1966 the rate was 3.8%. It also had very low inflation. Indeed, at the start of the decade, the US was flirting with deflation and by 1965, annual price inflation stood at just 1.6%. At the time, the Federal Reserve was in no hurry to normalise rates and only did so in 1964 and late 1965. Meanwhile government spending was rising because of the Vietnam war and a campaign to end poverty by Lyndon Johnson. The result was that both fiscal and monetary policy were extremely loose at a time of low unemployment and inflation. Something had to give and that was inflation. By 1970, inflation was rising at just under 6% a year. This preceded the period of ultra-high interest rates, which then saw a decade long bear market for fixed interest investors that lost more than a third of their money in real terms!

Inflation in the US and the UK has been steadily rising over the last few years and the concern now is that tighter monetary policy i.e. higher interest rates, may be required to avoid significant headline inflation figures in the next few years. This would have a knock-on effect to corporate profitability and hence share prices as the cost of servicing their debts would increase. The prospect of higher inflation in the US is also perhaps more relevant, given Donald Trump’s recently announced intention to impose tariffs on steel imports. Furthermore, the new Federal Reserve Chairman, Jerome Powell, is not known for taking a pragmatic view to soothing markets and is likely to target inflation with higher interest rates. Therefore, we believe that increased volatility will be seen this year.

It is impossible to predict the future - especially if stocks and shares will fall or rise. Therefore, it is important that medium to long term investors maintain a diversified portfolio to benefit from stockmarket rises when they happen and to dilute volatility when there is a fall. We strongly believe that a sensible investment strategy involves riding out stockmarket volatility.

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